



State Street Corporation

Stefan M. Gavell  
Executive Vice President and Head of  
Regulatory, Industry and Government Affairs

State Street Financial Center  
One Lincoln Street  
Boston, MA 02111-2900

Telephone: 617.664.8673  
Facsimile: 617.664.9339  
smgavell@statestreet.com  
[www.statestreet.com](http://www.statestreet.com)

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Robert de V. Frierson, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

RE: Docket Number R-1505 and RIN 7100 AE-26

Via e-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

**Notice of Proposed Rulemaking - Risk Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies**

Dear Sir/ Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the Notice of Proposed Rulemaking ("NPR") issued by the Board of Governors of the Federal Reserve System ("FRB") regarding the implementation of additional risk-based capital guidelines for certain United States ("US") bank holding companies ("BHCs"), including a capital surcharge for those BHCs which have been identified as Global Systemically Important Banks ("G-SIBs"). The proposed capital surcharge is intended to be consistent with the international standard adopted by the Basel Committee on Banking Supervision ("Basel Committee") regarding the assessment methodology for G-SIBs<sup>1</sup>, while also accounting for concerns relative to the funding profile of the largest, most interconnected US banks, specifically the scope of their reliance on short-term wholesale funding. While we recognize the importance of strengthening the resilience of the US financial system and of limiting the emergence of potential systemic instability, we have serious concerns regarding the measure of short-term wholesale funding proposed by the FRB and therefore the amount of the required risk-based capital surcharge.

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<sup>1</sup> 'Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss-Absorbency Requirement', Basel Committee on Banking Supervision (July 2013).

This reflects, in our view, the fundamental mischaracterization of certain deposit funded liabilities in the NPR, including in the case of custody banks, excess deposits derived from the provision of core safekeeping and asset administration services.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With \$28.2 trillion in assets under custody and administration and \$2.5 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets. State Street is organized as a US BHC, with operations conducted through several entities, primarily its wholly-owned insured depository institution (“IDI”) subsidiary, State Street Bank and Trust Company. As of December 31, 2014, our Basel III advanced approach common equity Tier 1 (“CET1”) ratio was 12.5% and our *pro forma* Basel III standardized approach CET1 ratio was 10.8%. Our estimated *pro forma* supplementary leverage ratio equaled 5.7% at the level of the BHC and 5.1% at the level of the IDI.

Our perspective in respect of the NPR is broadly informed by our status as one of eight designated US G-SIBs, as well as our role as one of the world’s largest providers of custody services to institutional investor clients. These clients include asset owners, asset managers and official institutions, and encompass US mutual funds and their non-US equivalents; corporate and public retirement plans; sovereign wealth funds; central banks; alternative investment funds; insurance company general and separate accounts; charitable foundations and endowments. We appreciate the opportunity to offer insight relative to the impact of the NPR on our role as a custodial entity, a role that is widely understood by the market and by the supervisory community as providing important benefits for the safety of client assets and the stability of the financial system.

We have participated in the development of the responses prepared by various financial services trade groups, notably the joint submission from The Clearing House Association, the Securities Industry and Financial Markets Association, the American Bankers Association and the Financial Services Roundtable, and we generally support the observations and recommendations made therein. Our intention with this letter is to highlight issues of particular concern to State Street that result from our custody bank business model.

## INTRODUCTORY COMMENTS

State Street recognizes the importance of a risk-based capital surcharge for G-SIBs in order to reduce the probability of insolvency and appropriately internalize the cost of heightened systemic risk. We also believe that the five indicator approach adopted by the Basel Committee for assessing systemic importance, based upon a G-SIB’s relative size, interconnectedness, cross-jurisdictional activity, substitutability and complexity is generally sound, and when resulting in a capital surcharge of between 1% and 2.5% of CET1 capital, provides for a meaningful reduction of system-wide risk, along with proper incentives for banks to improve their risk profile. Furthermore, we support the FRB’s efforts to limit excessive industry reliance



on unstable sources of wholesale funding. This includes implementation of the Liquidity Coverage Ratio (“LCR”) as a means of addressing potential instances of short-term idiosyncratic or financial market stress, and anticipated rulemaking on the Net Stable Funding Ratio (“NSFR”) designed to promote greater resilience in longer-term industry funding profiles.

Nevertheless, we have important reservations regarding the methodology proposed by the FRB for assessing the extent of a firm’s reliance on short-term wholesale funding. The FRB emphasizes in the NPR that its focus on short-term wholesale funding reflects two interrelated concerns: possible run risk associated with a systemic event and fire sale risk resulting from the forced liquidation of assets. This dual emphasis is, in our view, appropriate since the effective management of a firm’s liquidity risk requires the implementation of a robust asset management and liability management strategy. This is also consistent with the design of the Basel III liquidity framework, which seeks to measure a firm’s net liquidity position taking into account both available sources of funding and expected funding needs over a prescribed short- and a longer-term horizon. However, in its current form, the FRB’s measure of short-term wholesale funding only takes into account the assumed run risk of a firm’s liabilities and not the fire sale risk associated with the offsetting assets.

Furthermore, the FRB’s methodology is punitive in its approach to various sources of non-operational deposits, which are not distinguished according to their origin and which are uniformly assumed to have no liquidity value. In the particular case of custody banks, this is reflected in the treatment of excess custody deposits as short-term wholesale funding, even though these deposits are linked to the provision of safekeeping and asset administration services and are not used as a means of funding the custody bank balance sheet. Instead, these deposits are managed via the placement of cash with national central banks, or via investments in certain highly liquid assets, such as short-dated US Treasury obligations. In order to correct these limitations, we recommend an adjustment to the intended definition of short-term wholesale funding, designed to permit the exclusion of excess amounts of custody deposits when offset by essentially riskless assets. In addition, we offer our views on the nature and characteristics of operational deposits and therefore their proper treatment in US prudential regulation.

### CUSTODY DEPOSITS

As extensively discussed in several of our comment letters to the FRB, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively the “federal banking agencies”), custody banks such as State Street are uniquely focused on serving the day-to-day investment needs of institutional investor clients.<sup>2</sup> These clients contract with

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<sup>2</sup> State Street Corporation comment letters on the Joint Notice of Proposed Rulemaking – Enhanced Supplementary Leverage Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions (October 2013); Joint Notice of Proposed Rulemaking – Liquidity Coverage Ratio: Liquidity Risk

custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of associated financial services. This includes access to the global settlement infrastructure in order to complete the purchase or sale of investment securities; various asset servicing functions, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscriptions and redemptions; and the provision of banking services, notably access to deposit accounts in order to facilitate transactional activities. Indeed, the strong operational dependencies of the custody bank business model is one of the primary factors that led the Basel Committee to incorporate within its liquidity framework, a specific category for operational deposits as distinct from wholesale funding generally.

Since custody banks maintain the primary operational accounts of institutional investor clients, they are the recipients of substantial day-to-day deposit flows. In addition, they hold client deposit balances associated with the prudent management of investment assets. These balances are maintained by clients to address anticipated and unanticipated funding needs stemming from various operational considerations. This includes failed securities transactions, the non-receipt of payments, timing differences in the movement of cash, and client redemption activities, and will vary according to the investment profile of the fund. As an example, equity portfolios typically have higher balances due to the need to manage settlement cycles that can extend over a period of three or more business days. This is also true of emerging market portfolios, which must account for timing considerations in the execution of foreign currency transactions across numerous global markets. As such, custody banks and their clients view these balances as an integral component of the investment process, and therefore as an important element of overall custody deposit flows.

Custody banks, such as State Street, have balance sheets that are constructed differently than other G-SIBs with extensive retail, commercial, investment banking and capital markets operations. Custody bank balance sheets are built around client deposits derived from the provision of core safekeeping and asset administration services. These deposits represent a stable source of funding, whose value is monetized by custody banks via the purchase of large and well-diversified portfolios of high-quality and appropriately-termed investment assets. Unlike most other G-SIBs, custody banks make relatively few loans and do not engage in the loan securitization process. They also do not undertake significant trading or capital markets activities and do not rely extensively on sources of wholesale funding, such as certificates of deposits and commercial paper, to manage their business activities or balance sheets.



## TREATMENT OF OPERATIONAL DEPOSITS

The FRB proposes to require G-SIBs to calculate their risk-based capital surcharge, ranging from 1% to 4.5% of additional CET1 capital, using two discrete methodologies. The first, the Method 1 Surcharge, replicates the international standard adopted by the Basel Committee and encompasses five measures viewed as proxies for global systemic importance: size, interconnectedness, cross-jurisdictional activity, substitutability and complexity. The second, the Method 2 Surcharge, removes the substitutability indicator and replaces it with a quantitative measure of short-term wholesale funding.

Under the proposed rulemaking, operational deposits as defined within the US LCR final rule are excluded from the definition of short-term wholesale funding. The FRB indicates, in this respect, that since operational deposits 'are tied to the provision of specific services to customers, (they) present less-short-term liquidity risk during times of stress'.<sup>3</sup> The inherent stability of operational deposits is also recognized by the Basel Committee which emphasizes the need for clients to 'leave (such) deposits with a bank in order to facilitate their access to and ability to use payment and settlement systems, and otherwise make payments'.<sup>4</sup>

Under US prudential regulation, operational deposits are limited to a series of enumerated financial activities provided as part of 'cash management, clearing or custody services'. In addition, the classification of deposits as operational is conditioned upon meeting a series of stringent qualification requirements, specifically:

- The deposit must be held pursuant to a legally binding written agreement, subject to termination or switching costs;
- There must be a lack of significant volatility in the average deposit balance;
- The deposit must be held in a specifically designated operational account;
- The deposit must be held for the primary purpose of obtaining the operational service rendered;
- The deposit account must not provide economic incentives to maintain excess balances;
- The deposit must be empirically linked to the operational service rendered and cannot include 'excess amounts';
- The deposit balance cannot relate to the provision of prime brokerage services;
- The deposit balance cannot relate to the provision of certain correspondent banking services.

These requirements are designed to ensure that banks making use of the operational deposit category are actually conducting the operational activities in the manner intended. As such, we

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<sup>3</sup> 'Notice of Proposed Rulemaking: Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Banks', Federal Register Volume 79, Number 243 (December 18, 2014), page 75487.

<sup>4</sup> 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools', Basel Committee on Banking Supervision (January 2013), paragraph 93.

strongly support the FRB's decision to exclude operational deposits from the definition of short-term wholesale funding in the Method 2 Surcharge, since this accurately reflects the highly stable nature of our custody deposit base. Furthermore, we equally strongly oppose the FRB's alternative proposal to treat operational deposits as short-term wholesale funding with a 25% weighting, since this would result in the fundamental mischaracterization of the cornerstone of the custody bank balance sheet.

There is substantial empirical evidence that deposits held by custody banks are stable over a multi-year horizon and therefore do not represent the type of funding that is intended to be captured in the assessment of short-term wholesale funding risk. This can be seen, among other, in the relationship that exists between cash balances held and cash payments made in client deposit accounts based upon the cash management practices of the underlying investment fund. This approach directly captures the practices of custody clients and is used across the industry to establish the appropriate level of operational deposits. We are happy to expand upon the results of this approach with the FRB if it is found to be useful.

### TREATMENT OF EXCESS CUSTODY DEPOSITS

As noted in the prior section of our comment letter, one of the criteria for the categorization of deposit balances as operational is the requirement to exclude 'excess amounts'. Under the terms of the US LCR, this involves implementation of a 'methodology for identifying.... deposits....at a sufficiently granular level to adequately assess the risk of withdrawal', backed by 'supporting documentation that justifies' the methodological assumptions made.<sup>5</sup> Operational deposits which are identified by a firm as 'excess amounts' are treated as wholesale funding, and as such, require the firm to hold a corresponding amount of easy to liquidate high-quality liquid assets. While we recognize the logic of this construct for purposes of liquidity regulation, we are deeply concerned that when applied to the Method 2 Surcharge, this approach results in the broad mischaracterization of the custody bank balance sheet.

More specifically, the use of LCR parameters in the Method 2 Surcharge results in the erroneous assumption that excess deposits resulting from custody-related activities represent short-term wholesale funding, even though these deposits are closely linked to safekeeping and asset administration service, and are not used as a means of funding the custody bank balance sheet. In our view, this mischaracterization of the funding profile of excess custody deposits largely reflects the lack of any recognition in the FRB's Method 2 Surcharge for the way in which deposit liabilities are managed on the asset side of the balance sheet. As a result, the FRB's approach would effectively require banks, such as State Street, which make extensive use of

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<sup>5</sup> 'Liquidity Coverage Ratio: Liquidity Risk Management Standards', Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve, and the Federal Deposit Insurance Corporation, Federal Register Volume 79, Number 197 (October 10, 2014), page 62.



central bank placements to manage their deposit funded liabilities, to hold risk-based capital for essentially riskless assets.

As previously noted, custody banks maintain the primary operational accounts of their institutional investor clients. This includes residual cash, which is a normal byproduct of the client investment allocation process and which varies according to each client's investment mandate and view of the financial markets. Custody banks therefore tend to experience significant movements of cash during periods of financial market uncertainty as institutional investors seek to adjust their risk exposures or otherwise rebalance their investment allocation. This can, in turn, result in large client deposit inflows and therefore variability in balance sheet assets.

As an example, in the days following the Lehman Brothers insolvency, State Street experienced a rapid increase in client deposits of \$53.8 billion, or 36% of our total client deposit base. Similarly, during the US debt ceiling crisis of late-2011, client deposits surged by \$27.9 billion, representing an additional 18% increase in our deposit balances from levels already impacted by general financial market stress. More recently, State Street has experienced elevated levels of client deposits as a result of quantitative easing and macro-economic uncertainty in both the US and Europe. In our view, it would be highly unreasonable if a measure intended to discourage excessive reliance on short-term wholesale funding, were to lead to a broad increase in a firm's risk-based capital due to transitory deposit inflows offset by either central bank placements or investments in certain highly liquid assets, such as US Treasury obligations. This is especially true for central bank placements which are not subject to any loss of value, along with either duration or fire sale risk.

We therefore recommend that the FRB incorporate within its approach an adjustment for excess amounts of custody deposits when offset by a defined category of essentially riskless assets. More specifically, we suggest the exclusion of excess custody deposits from the Method 2 Surcharge, capped by (i) 100% of placements held at a national central bank and (ii) 75% of a firm's total level 1 assets, with the adjustment to level 1 assets designed to reflect the highest weighting prescribed for secured funding transactions backed by level 1 assets in Table 8 of the NPR. In addition, we suggest that excess custody deposits be defined as 'deposits resulting from the provision of custody services relating to the financial activities enumerated in Subpart A, Section 3 of the LCR final rule, that do not otherwise meet the criteria for operational deposits as specified in Subpart A, Section 4(b).'

There are, in our view, several advantages to this approach. First, it is highly targeted and is intended to correct the anomalous treatment of a discrete category of deposit funding without undermining the FRB's underlying policy intent. Second, it is designed to be consistent with the FRB's decision to rely in its NPR, on definitions and standards prescribed in the LCR final rule. Third, it recognizes the unique characteristics of central bank placements, while also ensuring that excess custody deposits invested in level 1 assets are treated in a manner consistent with economically similar secured funding transactions. Finally, this approach is self-limiting and is

appropriately sensitive to changes in financial market conditions, including a more normalized interest rate environment.

## CONCLUSION

Thank you once again for the opportunity to comment on the important matters raised within this consultation. To summarize, while State Street recognizes the importance of a risk-based capital surcharge for G-SIBs and supports efforts to reduce excessive industry reliance on unstable sources of wholesale funding, we have pressing concerns regarding the approach to short-term wholesale funding adopted by the FRB in the Method 2 Surcharge. This reflects its punitive treatment of various sources of non-operational deposits, including excess custody deposits, which are closely linked to the provision of safekeeping and asset administration services and which constitute an important component of the custody bank balance sheet. This also reflects the lack of recognition in the NPR for the asset-liability management practices of banks, including in the case of custody banks, extensive reliance on essentially riskless assets.

We strongly support, in this respect, the FRB's proposal to exclude operational deposits from the definition of short-term wholesale funding. Furthermore, we equally strongly oppose the alternative proposal to treat operational deposits as short-term wholesale funding with a 25% weighting, since this would simply aggravate concerns relative to the mischaracterization of our custody deposit base. In order to better accommodate the particular characteristics of the custody bank business model, we recommend that the FRB consider the introduction of an adjustment in the Method 2 Surcharge for certain amounts of excess custody deposits when offset by essentially riskless assets. More specifically, we recommend the exclusion of excess custody deposits from the measure of short-term wholesale funding, capped by (i) the sum of all placements held at national central banks and (ii) three-quarters of a firm's total level 1 assets, with the adjustment to level 1 assets designed to ensure consistency of treatment with equivalent secured funding transactions, as foreseen in table 8 of the NPR.

Please feel free to contact me at [smgavell@statestreet.com](mailto:smgavell@statestreet.com) should you wish to discuss State Street's submission in further detail.

Sincerely,

A handwritten signature in black ink, appearing to read 'Stefan M. Gavell', written in a cursive style.

Stefan M. Gavell